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## DISCUSSION OF GOVERNMENT'S FINANCIAL POLICIES IN RELATION TO INFLATION

### I

A. BARTON HEPBURN

Chase National Bank

Mr. President, I am reminded of the story of a man who while addressing a large audience was disturbed by calls from the rear of the room of "Louder! Louder!" Finally some one in the center of the audience said, "Can't you hear what the speaker is saying?" The response was "No!" "Well," he said, "you are mighty lucky."

(Upon request, Mr. Hepburn then stepped up to the platform.)

Mr. Chairman, Ladies and Gentlemen: My comment on the addresses to which we have listened is one of general agreement and commendation. I want especially to endorse the views expressed by Dr. Willis upon the question of inflation and deflation, and the responsibility of the Federal Reserve Bank in reference to existing conditions.

We struggled here in this country for forty years to amend our archaic banking laws, and finally succeeded. My objection to the present law was that it created twelve regional banks. I thought we ought to have one central bank, with branches wherever necessary. That is the conclusion one naturally reaches after a study of the banking systems of other countries; the central bank system is perfectly logical, and should have been adopted in the United States. But the administration of the Federal Reserve banking system has made it a central bank; the system is absolutely dominated by the Federal Reserve Board at Washington and the Secretary of the Treasury, more particularly the latter so far, because of the extreme needs of the Government in its financial operations during the war. In its administration, I think that the system is worthy of all credit, and we are very much to be congratulated upon having it in force in our country.

Dr. Willis alluded to the fact that it was regarded as a superman and more was expected of it than could be realized; that is true. At the time our Federal Reserve legislation was pending the Chamber of Commerce here in New York invited Carter Glass and Sen-

ator Owen, Chairmen of the respective finance committees of Congress, to come to New York; they tendered them a reception and requested them to discuss the proposed Federal Reserve law. Each one of them made the statement that we never could have a panic again in this country; they made the statement not only upon that occasion, but they interwove that idea into their respective speeches wherever they appeared and made addresses; and that thought was given currency all over the country. Of course, I suppose it was born of the fact that the panics recently experienced were the result of money stringency. They had been caused by the hoarding of money by the people, coupled with the inability of the banking system to increase the circulation. A bank had to pay more for Government bonds as security than it could issue in circulating notes. The only way to relieve the situation was to buy gold abroad and import it. We cannot now have a money stringency panic, but we can have panics in this country, and unless I am very much mistaken, we are heading toward one now; there are all the elements of danger not only underneath the surface but right on the surface, and no panacea will correct them except economy and conservatism.

The price level (which Dr. Willis tells us cannot be maintained and perpetuated), as we all know, is the result of the law of supply and demand, and when the demand is vociferous, as it was during the recent war, the prices of commodities respond to that demand and rise, and as they rise, credit instruments in one form or another have to be made to consummate purchases. Necessary it may be, but, as Dr. Kemmerer told us, it has resulted in inflation in every war of major consequence. You can't maintain that the price level is stabilized, it is useless to try, and as prices advance, more credit instruments are created. But, gentlemen, please bear in mind that they follow the demand and are created to pay and consummate trades made. They do not, as some of our economists tell us (Dr. Kemmerer included), create the advance in prices; they follow the demand and satisfy it.

Dr. Kemmerer told us all about the inflation which we have had, and its causes, in a most explicit manner, very fully and accurately, and without prejudice or criticism, he gave a very illuminating discussion of the subject, and, barring this one criticism on his adoption of the quantity theory of money as to the regulation of prices, I am quite in agreement with him.

Now no one realizes better than a banker the very great problem that confronted our Government during the war, wholly unprece-

dented, and any comment or criticism made upon the administration should be made with full appreciation of the difficulties which confronted these gentlemen at Washington, and be leniently made for that reason, and only in the hope of leading to an avoidance of similar mistakes in the future.

I was very much surprised at Secretary Leffingwell's comment upon the lack of criticisms of the Government's action during the war, and the fact that criticisms were reserved until the present time. Everybody knows that criticism, or suggestion, or information are among the things that this Government at Washington does not want, and would not listen to. But I am sorry the Secretary isn't here, because I could call his attention to a number of things that were criticized, and the Government did know what the public thought about them. To begin with, there never was a more undignified proceeding inaugurated than the propaganda to float Government bonds and sell them to the public at more than they were worth. The Liberty Bond Committees took possession of our theatres, between the acts; they came into our banking institutions and held us up at all times; they got people's enthusiasm aroused and induced them in many cases to subscribe for more than they could pay for.

What the Government should have done was to have paid a fair price for money, paid what the bonds of the State of Massachusetts, or Minnesota, or New York were paying, or what the bonds of the City of New York were paying; they never should have offered bonds to the public at any lesser rate than the first credit existing in the country commanded. Had that been done, the twenty-two million who subscribed for bonds at one issue would have kept them and the bonds would have remained near par. But, as it was, the degree of patriotism of these people aroused by propaganda did not continue when their securities went down, and in a spirit of disappointment they sold them, usually at considerable loss, and they are going out of the hands of the general public and into the hands of strong holders.

This war has cost a great deal, and it has been paid for in various ways. You pay taxes; that you know. If you buy anything in a drug store or a dry goods store, you pay a little additional tax; you are reminded of that all the while. But what you may forget is that you are paying a tax every day, directly or indirectly, in the high rates of money. The very best mercantile credit in the country is paying eight per cent for money. Don't you pay that in the form

of increased cost when you trade with them? Surely you do! And why must you pay it? The Government today has six and a half billions of the money of the commercial banks, who are supposed to supply the commercial needs of the community; the withdrawal of that amount from the discount banks, removal of it from their supply of funds available for loans to merchants and individuals, accounts for your increased rate of money. This is part of the worst tax, the heaviest tax, the biggest tax, that you are called upon to pay, the increased cost of everything that you have to buy, comprehended in the phrase, "High cost of living."

Now if the Government had placed its bonds at an interest rate which would have kept them at par, kept them in circulation and in the hands of the community, they would not have been in the banks; the banks could have supplied your needs, and the price level would not have risen to so great an extent.

Instead, what did the Government do? It spent millions of dollars in this propaganda work, employed people and paid their expenses all over the country, to boom the Government bonds, a thing which would be a reflection upon the credit of any individual or any corporation; but that method was followed for every bonded issue offered the public. When the Treasury Department was organizing those booms for succeeding bond issues, they went into the market, to Wall Street, and bought bonds to sustain the price, marked them up, did just as brokers do and bankers do down there, which people criticize so much, and they have kept that up until just recently Secretary Houston announced the discontinuance of that policy. How much money do you suppose they spent in that way? They bought \$1,839,000,000 of their funded debt which had been sold to the public, paid for the same with these revolving certificates of indebtedness, running from four to six months, which are placed with the banks at frequent intervals. Is that good business? Is that good banking? Was that necessary?

Now the Federal Reserve Bank did not have anything to do with this policy. I am a member of the Advisory Council of the Federal Reserve Bank, and they were all opposed. The methods that should be criticized are the methods that have emanated from the Treasury Department; and the Secretary of the Treasury has been given absolute control, practically, and rightly so, because of the enormous needs of the Treasury and the very great difficulty he had in meeting those needs.

I have mentioned briefly the principal causes which affect the price

level as it exists today, and which you are compelled to reckon with in the daily lunch-basket, in the daily administration of your household, and some other things that ought to have been, and could have been, avoided. The Government did not print greenbacks, as they did in 1865, and make them legal-tender; they did not ask the banks to take their certificates. But they notified the banks that they were expected on certain dates to credit the Federal Reserve Bank, as fiscal agent of the United States, with specified amounts for which they would receive certificates, bearing a specified rate of interest. And we did it; we did it cheerfully; we did everything which we were asked to do during the war; and we didn't criticize. We were not afraid they would call us "Pro-German", but we thought that the Government was engaged in a very great struggle for which it was illy equipped and not overcompetent, and we thought we might possibly militate against its success in winning the war if we expressed adverse opinions, so we simply grinned and bore it; and we are inclined to continue in that attitude at present. It is our Government, this is our Nation, and we are going to win out; but the situation might have been made much easier for us, as a people, as taxpayers, if some things had been avoided.

Dr. Willis has told about the vicious cycle of raising wages and then raising costs; but we have gotten to a point now where that doesn't any longer produce a favorable effect. We are speculating in this country not only on the stock exchange, but in commodities and in real estate, and in things that are local to the different sections of the country, to a tremendous extent; and that ought to be curtailed in some way. It cannot be done forcibly. We are also speculating very largely in foreign securities—for instance, take bonds of the City of Frankfort and other cities of Germany. The mark is worth over twenty-four cents normally; it is worth less than two cents now. Just think of it, one dollar can be made to count twelve times, in purchasing a bond of one of those first-class German cities, and it has been done to a very large extent. Other people have gone a little further and bought foreign exchange, in the belief that it would advance at some time. But for the banking community I want to say that we have been financing Europe in every legitimate way for a long time. We would not buy the Government bonds over there of nations that were not raising taxes enough to pay current expenses; we would not lend them money on which to live, but in the City of Prague, for instance, we made a syndicate, bought \$9,000,000 worth of raw cotton, sent it to them (and are sending it

to them) for which they execute a trust receipt, agreeing to hold the cotton as the property of the syndicate and to manufacture it into finished goods and sell into the markets of this country enough of those finished goods to pay the original cost, the balance to be used as they see fit. In that way, you will notice, we get rid of the exchange which runs so strongly against them; they sell their product here; they make dollar exchange; they avoid the high rates of exchange. The same thing has been done in copper. As an investing community, as a banking community, we are doing all that can be done within the limits of safety, to finance the industries of Europe, even of those Governments over there which are not paying their way, and those newly created or half-born Governments that exist on paper only, which of course have no standing or credit. The banks of this country do not own the money they have on hand; they are simply trustees for it, and must exercise conservatism.

## II

JACOB H. HOLLANDER

Professor of Political Economy, Johns Hopkins University

The meaning of "inflation", its extent and its effects, have been discussed with such clearness and agreement that no further comment is necessary. The causes and the remedies remain to be considered.

I shall be compelled, however, in harmony with the suggestion of the chairman, to deflate the discussion of causes and to dwell only briefly on the remedies. I do this with regret. For after all, our prime interest as economists lies in clear recognition of the causes of inflation. Moreover, it is our duty to set forth these causes for three reasons: First, in order that there may be a definite assignment of responsibility both as to policies and as to persons; this in no vindictive or hyper-critical sense, but as the one sure way in which we are likely to avoid like error in the future. I venture to say that it has only been the clear understanding in the public mind of the mistakes of Secretary Chase as to greenback financing in the Civil War that prevented us, alone among the nations engaged in the World War, from reverting to a policy of inconvertible paper money. In the second place, unless we understand our mistaken policies, we are likely to continue pursuing the same errors. And, thirdly, unless we know what the causes are, we shall certainly not adopt wise remedies.

There was agreement, I think, in this morning's discussion that a war can be financed in three ways: by taxes, by loans, or by issuing paper money. But there is one further way in which a war can be financed, which has not been mentioned, except incidentally by Mr. Hepburn, whose encyclopedic knowledge of money and banking, barring only a curious stone-age survival, a belief in the unsoundness of the quantity theory of money, did not permit him to omit the very large part which direct borrowing from the banks may play in war finance. It is this large continuing reliance of our Treasury upon direct bank borrowing that I regard as, if not the most important, certainly the most neglected cause of inflation.

I take it, before a company such as this, it is certainly not necessary to say that if the United States Government had pursued the financial policy followed in the Civil War and struck off additional United States notes and used them in paying the munition-makers and the ship-builders, the effect would have been higher prices, just as during the Civil War. But if, realizing the magnitude of the financial requirement and the limitation of printing presses, the Treasury, instead of increasing the supply of notes, had adopted methods which increased the supply of bank deposits, so that instead of making its payments with notes it would have made such payments by check, the effect would have been identically the same. In other words, if the United States, instead of using the bank credits which individuals had in their deposit accounts, had created bank credits of its own, there would have been an addition to the deposit currency of the country, just as clearly as there would have been an addition to the note currency of the country had it printed greenbacks. The term "fiat credit" could be applied just as appropriately to such government deposits as the term "fiat notes" could be applied to the greenback. Now this is precisely what we did during the World War—not only from the summer of 1917 until the armistice, but what we have since continued to do until the present. We have done this through the device of Treasury certificates of indebtedness. Designed originally as a mode by which the Treasury might anticipate the proceeds of war taxes and loans, just as any city anticipates tax revenue by the issuance of tax warrants placed with the banks, the certificates of indebtedness were gradually permitted to degenerate into a habitual mode of creating credit, credit which was before non-existent, which did not represent the diversion of deposits from individual Government accounts, but which represented new creations unrelated to commercial requirements, tracing

their warrant to Governmental fiat as distinctly as the greenback issues of Secretary Chase.

The mode of procedure was very simple. The Secretary of the Treasury, at more or less regular intervals, issued and placed with the banks, by a manner of administrative compulsion such as Mr. Hepburn has described, an amount of certificates of indebtedness. The banks paid for these, not by taking credit from other quarters, but by writing upon the page of its ledger headed "government deposits" so many millions of additional credit. Thereafter the Government drew upon those credits by transfer to the Federal Reserve banks, and then liberated them in ordinary disbursement. Thereafter they found their way into the deposit accounts of the ship-builders and munition-makers, operating precisely as though the Government had taken from its presses brand-new, fresh-engraved notes and used them in payment of its bills. In other words, additional credit was created by Government fiat, utterly unrelated to commercial requirement. This credit, disbursed in the course of Government expenditure, found its way into individual accounts and tended to swell the amount of deposit currency over and above the amount of note currency.

Just one word more, for I do not mean to abuse my allowance of time.

What has been said as to the imperviousness of the Treasury to suggestion not only as to individual opinion but as to actual experience and as to positive recommendation, I think in this particular is true beyond question. The Cunliffe commission in England had made careful investigation and had traced word for word and item for item the unwholesome course of this process of bank borrowing, and a competent group of experts in the United States had condemned it. But, leaving aside what was done in the first instance as, after all, involved in the wastage and losses of the war, we face the hard fact that this process continued with accelerated speed after the armistice, and only within the last month, under the administration of Secretary Houston, who for the first time has injected a degree of candor and ingenueness into the borrowing operations of the Treasury, this process of fiat-credit making has continued and impends with respect to the further financing of the floating debt. In other words, the United States has now practically three billions of unfunded floating debt in the form of certificates of indebtedness, largely held by the banks, that will mature between now and next April.

It depends upon the policy which is adopted now, whether we are to continue the same process of renewing and extending that debt by the creation of further fiat credit, or whether we shall adopt the measures which England in the last two weeks has adopted, with a fine courage harmonizing with her brilliant financial tradition. We must extinguish that debt by spending less or taxing more, or we must fund it so that it will be absorbed by investors out of existing deposits. If we fail to do any of these things, and pursue the methods which we pursued during the war and after the war, by renewing the floating debt, through the issuance of additional or continuing certificates of indebtedness, taken in the main by the banks, paid for by the creation of additional credit against which no reserves need be held and upon the taking of which no limit therefor is imposed upon the banks, if we do that, our talk of deflation is as futile as the talk of lifting ourselves by tugging at our bootstraps.

### III

DR. B. M. ANDERSON, JR.

National Bank of Commerce

I want to talk about certain things which Professor Willis has indicated as the more important matter. Constrained, by the assignment of the topic, to talk about banking, he has indicated that the more fundamental things are in the fields of production, consumption and the like, and that is where the emphasis, it seems to me, belongs. I am one of those economists of Professor Hollander's "stone age", who join with Mr. Hepburn, Professor Mitchell, Professor Willis, and others in being skeptical of the quantity theory, although recognizing, I trust, a good many of the factors which adherents of the quantity theory have emphasized this morning.

The central point in the explanation of the present high prices of the United States, with our gold standard, is shortages of goods and the speculation attendant upon those shortages. The basic cause of the shortages is the enormous excess of exports over imports, which has been going on for the last five and a half years, and which has been greater since the armistice than it was before the armistice, running \$336,000,000 in the month of March of this year; running \$625,000,000 in June of last year; and averaging \$350,000,000 or more per month since the armistice. When this export balance disappears, and when our domestic markets are called upon to absorb

three or four hundred million dollars worth of goods per month that they are not now absorbing, we shall see lower prices.

The export balance does not tell the whole story, of course. We diverted labor, engaged largely in producing peace-time goods, to producing cantonments, ships, shipyards, factories for making aircraft and the like during our own participation in the war. We withdrew five million men from industry for the Army and Navy. When these men returned last year in large part to industry, we naturally expected an increase in production. It has not come. The year 1919 showed a reduction in the physical volume of production of at least ten per cent, I suppose. All who have investigated the matter seem in agreement that there is a substantial reduction, despite the return of the soldiers to industry, in the physical output of 1919 as compared with that of 1918.

Coupled with this decreased production, which I attribute to the prolonged strain and resultant derangements in our industrial system which the war has involved, came a great increase in our export balance of trade and a great increase in domestic consumption as our people relaxed from war-time economy and swung to the opposite extreme. The net result of diminished production, increased excess of exports over imports, and increased domestic consumption and extravagance, is that shortages of goods are markedly greater at the present moment than they were at the time of the armistice.

Now in normal times the world lives from hand to mouth. It was estimated, before the war, that England would usually have about a six weeks' excess of food on hand and that an interruption of shipping for six weeks would mean that England would be brought to the verge of starvation. I have estimated roughly that in the United States, in the year 1912, a normal year, we had on hand in the form of consumers' goods ready, or nearly ready, for the market about a three or four months' supply. That is a liberal estimate. The cessation of industry for three or four months would have brought the United States to direct famine and want. Any such interruption, therefore, of industry as the war involved, any such enormous increase of consumption as the war involved, shortens existing stocks of goods tremendously and brings the most acute shortages in many lines. The world lives from hand to mouth, and the surpluses have been enormously reduced. Now it is here, I think, that the emphasis belongs, rather than on the banking and monetary phenomena which certain of the speakers this morning have emphasized.

No doubt, if gold had not come into our system during the war,

we could not have expanded our bank loans as we have and at the same time maintained the gold standard. Probably we should have been forced off the gold standard, and in that case prices would have gone higher than they did go. But gold has been leaving for over a year now. Just about a year ago the gold embargo was removed. We have lost nearly \$400,000,000 in gold since that time. None the less, prices have gone up and banks have continued expanding at a tremendous rate, because of these factors in consumption, production and export. No doubt if the Federal Reserve banks had enforced a stronger discount policy earlier, we might have retarded that expansion somewhat, and prices might have been held back somewhat. But I call your attention to the fact that money has been tight since July and August last. Call rates in the stock market especially have been at prohibitive figures repeatedly since last August. No doubt if the Government had borrowed less and taxed more we should have forced more economy upon our people, and if the Government had made larger use of funding loans rather than of treasury certificates, which are taken chiefly by the banks, there would have been more economy forced upon the people.

But the fundamentals lie somewhere else. When the underlying factors change and prices turn downward again, bank loans and deposits in the United States will also decline. This happened at the time of the armistice. Following the armistice, there came a reaction in business. There came a decline in commodity prices, amounting to some ten per cent on Bradstreet's index number, which represents those wholesale goods on which bank loans are most likely to be made. Commercial borrowings fell off rapidly. I speak now as one who saw it from the inside of a bank. There came to the great New York City banks millions and millions of dollars daily, in one, two and five dollar bills, and other small currency, sent in from out-of-town banks. Payrolls were falling off; retail business was falling off in many centers, and the merchants didn't need so much hand-to-hand money. They turned it in to their local banks, who sent it in to the New York banks. The New York banks then turned it over to the Federal Reserve banks and reduced rediscounts. The volume of Federal Reserve Notes was reduced about ten per cent during that period. A liquidation process started, which would have gone far had it not been checked and reversed by that tremendous outpouring of goods to Europe, far in excess of the volume that had been going before, financed in the way that Professor Hollander objects to particularly, by the Government's borrowing from

the banks the funds which it loaned to Europe. That turned the scale. There came a revival, and a new boom started, which has gone on since.

One further point—a very brief one. One of the reasons why I don't accede readily to the type of reasoning that the quantity theory involves, is that it seems to me much more important to talk about the quality of money than to talk about the quantity of it. If the quality of it is right, it will adjust itself to the underlying factors. If the quality isn't right, you can get a very different situation. Our sound gold money and our sound banking system have primarily adapted themselves, passively, to the underlying facts. Where you have got away from the gold standard, your monetary phenomena are far more significant causal factors. Depreciated paper money throughout most of the countries of Continental Europe, despite their even greater scarcity of goods, is still the main cause of their high prices. Their prices have risen very much more than ours. It seems to me very important to distinguish between a price situation where you have the gold standard maintained, and a price situation where you have not maintained it.